Hong Kong Institute of
Certified Public Accountants
香港會計師公會

23 May 2011

By fax (2121 0420) and by hand

Your Ref.: CBI/BC/4/10
Our Ref.: C/TXG, M77351

Hon Paul Chan Mo-po, MH, JP
Chairman
Bills Committee on Inland Revenue (Amendment) (No.2) Bill 2011
Legislative Council Building
8 Jackson Road, Central
Hong Kong

Dear Mr. Chan,

Inland Revenue (Amendment) (No.2) Bill 2011

Thank you for giving the Hong Kong Institute of CPAs ("Institute") the opportunity to submit views on the Inland Revenue (Amendment) (No.2) Bill 2011. The bill proposes to provide a profits tax deduction for capital expenditure incurred on the purchase of three commonly-used types of intellectual property rights ("IPR"), namely copyrights, registered designs and registered trade marks. Currently, a tax deduction is allowed under section 16E of the Inland Revenue Ordinance ("IRO") for capital expenditure incurred on the purchase of patent rights and rights to any know-how for use in Hong Kong. However, it should be noted that, prior to 18 April 1991, section 16E also provided a deduction for patent rights or rights to any trade mark or design.

In principle, the Institute welcomes the proposal but is of the opinion that it does not go far enough. The government has stated that the aim of the proposal is to promote the wider application of IPR by enterprises, to encourage innovation and upgrading and to facilitate development of creative industries in Hong Kong. However, we believe the bill will not fully achieve this aim for reasons explained below.

Scope of deductions

1. The current and proposed provisions are quite limited in their scope and the proposed provisions arguably do little more than re-instate the pre-1991 situation. The relevant industries would benefit more if the concession were to be extended to a wider range of expenditure on intangibles.

   In order to illustrate the limited benefit of the proposal, consider a telephone company that incurs substantial expenditure to acquire a government licence to operate a telephone network in Hong Kong. While the telephone company will be taxed on its profits from the provision of telephone services, it will not be allowed to amortise for tax purposes the cost of the licence. By contrast, for

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

accounting purposes, the cost of the licence is amortised. Moreover, it is unclear from the proposal whether items, such as “customer lists” would be covered by the proposed IPR.

In this regard, the Institute recommends expanding the scope of IPR to be covered under the bill.

In addition, the proposed provisions allow a deduction only on purchased IPR and costs incurred in developing IP in-house or under a cost-sharing arrangement[1] would not fall within the scope of the legislation. While IP developed in-house may qualify for a deduction, as research and development, under section 16B, it is by no means certain that this would always be the case, and cost-sharing arrangements are unlikely to be eligible and may in fact be caught by the anti-avoidance provisions on associates. Therefore, we would suggest that both these kinds of IPR expenditure be covered specifically under this bill, to enable the legislation to achieve its stated aims.

Period for write-off of IPR expenditure

2. The IRO previously provided for an immediate tax write-off for expenditure on trade marks, copyrights and designs. The current proposal allows for amortisation over a period of five years (or less in certain circumstances) and, therefore, is not as generous as the previously-provided deduction. Furthermore, it does not compare favourably with other provisions of the IRO that provide for an immediate tax write-off, such as section 16B - expenditure on scientific research; section 16E - purchase of patent rights and industrial know-how; and section 16G - capital expenditure on prescribed fixed assets. The Institute recommends that the bill be amended to allow for an immediate write-off of the relevant expenditure.

Anti-avoidance provisions

3. The proposed new section 16EC is of particular concern. This is an anti-avoidance measure which imposes restrictions on the deduction available for IPR under “sale and license back” and “leveraged licensing” arrangements. The proposal potentially suffers from the same problem currently faced by Hong Kong manufacturers engaged in import processing under section 39E. The unfavourable impact of section 39E is that, notwithstanding the fact that manufacturers are subject to tax on profits from the manufacture of goods in the Mainland, they are denied a deduction for depreciation allowances on plant and equipment provided to factories in the Mainland to manufacture goods on their behalf.

   The Institute recommends that the proposed new section 16EC(4)(b) be amended, so as not to automatically deny a deduction to the Hong Kong owner in the situations where IPR is used outside Hong Kong by a person other than

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[1] Where the Hong Kong taxpayer co-develops IPR with its overseas group companies and shares the related costs with those companies.

the taxpayer. The following examples illustrate the potential negative impact of the proposed provision:

(i) Take the situation of an owner of IPR which licenses that IPR to a company to use outside Hong Kong, and assume that the source of the royalty income from the licence of the IPR is in Hong Kong and taxable. While the royalty income would be subject to profits tax in Hong Kong, the proposed section 16EC(4)(b) would deny the owner a deduction for the IPR.

We note the Administration's response of 6 April 2011 to the Legislative Council, in which it is indicated, at paragraph 7, that royalties derived from licensing IPR to another enterprise for use outside Hong Kong would be non-Hong Kong-sourced income (so, by the same token, no deduction of the related expenditure would be permitted). However, on the one hand, we are not entirely convinced that this would always be the interpretation adopted by the Inland Revenue Department ("IRD"), particularly in the light of paragraph 45(g) of Departmental Interpretation and Practice Notes No. 21, while, on the other hand, if this is the correct determination of the source of profits, it would follow that no deduction could in any case be claimed for the capital expenditure incurred on the IPR and so the proposed section 16EC(4)(b) would be superfluous.

(ii) Another example would be where the owner of the IPR contracts with a Mainland enterprise to manufacture goods on its behalf. It would seem that a deduction would be denied because the IPR would be treated as being used, not by the owner, but by the subcontractor in the Mainland. At the same time, the profits of the IPR owner would be regarded as chargeable to tax in Hong Kong, based on the experience of section 39E.

The proposed section 16EC(4)(b) will, therefore, be unfavourable to many normal business arrangements. We suggest that it be amended to cater for situations such as those outlined to above, or removed altogether on the basis that it is not necessary.

4. Under the proposed new section 16EC(2), no deduction will be permitted for expenditure on either the existing or new IPR, under section 16E or the new section 16EA, respectively, if purchased wholly or partly from an associate. On the other hand, there seems to be no reason to suppose that purchases of IPR from non-associated entities are anything other than arm's length transactions at market prices. This being the case, the need for the introduction of the proposed new sections 16E(8) and 16EA(9) is unclear. To elaborate further:

(i) The proposed provisions will allow the Commissioner to substitute his opinion of the true market value for the purchase or sale price of particular IPR, where he is of the opinion that the consideration "does not represent the true market value of the specified [IP] right at the time of that purchase or sale". We are not aware of any justification for granting this very wide statutory discretion, either in the light of the application of the existing provisions in section 16E, which cover patents and know-how, or due to specific concerns about the application of the proposed provisions on the new IPR. We consider that this will set an unhelpful precedent and suggest that the proposed sections 16E(8) and 16EA(9) be deleted. The existing anti-avoidance provisions in section 61A of the IRO can be invoked to deal with the rare cases where IPR transactions between unassociated entities may be motivated by tax avoidance.

(ii) We would also suggest that the supposed abuses, which the proposed new section 16EC(1) seeks to deal with, i.e., taxpayers purchasing IPR that have already been used by them under a licence purely to reap the tax benefits, could also be addressed by section 61A. As such, there should be no need to provide the Commissioner with a specific discretion to decide that the consideration for the purchase of IPR is not reasonable in the circumstances.

(iii) In relation to the very wide definition of "associate", we also question whether a partner should automatically be regarded as being an associate of a partnership, given that dealings between two equal partners should, in most cases, be arm's length commercial transactions.

Points for further clarification

5. In addition to the above matters, some further clarification of the following would be helpful:

(i) Under the proposed new section 16EA(2), a deduction will be permitted if the IPR are purchased for use in the trade, profession or business in the production of profits in respect of which the person is chargeable to tax. As regards the interpretation of the term "use", we have concerns that where, for example, IPR are licensed by the owner to another person for use in Hong Kong, it may not be entirely clear whether they will be considered as being used by the owner or by the licensee and, therefore, whether the owner will be able to claim a deduction. While we note the response in the Administration's letter of 6 April (at paragraph 10), referred to above, we still harbour some doubts that a narrower interpretation may be adopted in practice. We would suggest, therefore, that it be clarified in the legislation that "use" by the IPR owner could include licensing to a licensee for use in Hong Kong. As a minimum, in his speech during the passage of the legislation through the legislature, the Secretary for Financial Services and the Treasury should state that this interpretation is correct.

(ii) As registration of designs and trademarks is a pre-requisite for deductions to be claimed, a timing issue could arise if the acquisition and the registration straddle two years, or if the registration is delayed through no fault of the owner. It is not clear from the bill how these situations will be dealt with.

(iii) In situations where, for example, the registration is subsequently disputed or invalidated, what measures, if any, would be taken in terms of recapture of previously claimed deductions?

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The Institute recommends that committee stage amendments be made to the bill to address the concerns raised in this submission. This should help to make the legislation, when passed, more effective in achieving the laudable objective of supporting the development and competitiveness of creative industries in Hong Kong.

Should you have any questions on the Institute's submission, please contact me on 22877084 or at peter@hkicpa.org.hk.

Yours sincerely,

Peter Tisman
Director, Specialist Practices

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Encls.